



# Office of Inspector General

March 26, 2004  
Report No. 04-013

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FDIC's Reliance on State Safety and  
Soundness Examinations

AUDIT REPORT



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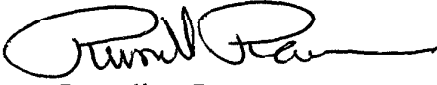


Federal Deposit Insurance Corporation  
801 17th St. NW Washington DC. 20434

Office of Audits  
Office of Inspector General

**DATE:** March 26, 2004

**MEMORANDUM TO:** Michael J. Zamorski, Director  
Division of Supervision and Consumer Protection



**FROM:** Russell A. Rau  
Assistant Inspector General for Audits

**SUBJECT:** *FDIC's Reliance on State Safety and Soundness Examinations*  
(Report No. 2004-013)

This report presents the results of our audit of the Federal Deposit Insurance Corporation's (FDIC) process used to rely on safety and soundness examinations performed by state banking departments. The objective of the audit was to determine whether the process used by the FDIC to rely on state safety and soundness examinations is adequate. To accomplish our objective, we reviewed Division of Supervision and Consumer Protection (DSC) policies and procedures for relying on state examination reports, focusing on the Dallas and New York regional offices. Also, we reviewed all working agreements entered into between the FDIC and state banking departments nationwide (see Appendix II). Appendix I of this report discusses our objective, scope, and methodology in more detail.

## BACKGROUND

The FDIC is the primary federal regulator for over 5,300 state-chartered financial institutions throughout the United States and its territories.<sup>1</sup> Collectively, these institutions have assets totaling over \$1.7 trillion.<sup>2</sup> Under section 10(d) of the Federal Deposit Insurance Act (FDI Act), all FDIC-insured institutions are required to undergo on-site examinations by "the appropriate federal banking agency"<sup>3</sup> every 12 or 18 months,<sup>4</sup> depending on asset size and bank performance. Bank examinations are performed to assess the safety and soundness of institutions and to

<sup>1</sup> This includes a small number of banks in Puerto Rico, Guam, American Samoa, the Federated States of Micronesia, and the Virgin Islands. At the time this report was prepared, there were no FDIC-supervised banks in the District of Columbia.

<sup>2</sup> The Federal Reserve Board supervises 937 state-chartered institutions that are members of the Federal Reserve System. These institutions have total assets of approximately \$1.9 trillion.

<sup>3</sup> The term "appropriate federal banking agency" is defined at FDI Act section 3(q) (12 U.S.C. § 1831(q)) in general to mean the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the FDIC, and the Office of Thrift Supervision.

<sup>4</sup> The FDI Act requires all FDIC-insured banks to be examined on a 12-month cycle. However, the Act allows the examination cycle to be extended to 18 months for banks with assets of \$250 million or less if other factors are met – primarily that bank performance is satisfactory and the bank is well managed and well capitalized.

identify weaknesses that could lead to failure.<sup>5</sup> In addition to federal regulation, all state chartered banks are subject to examinations by state banking departments. In accordance with the FDI Act, the FDIC may alternate bank examinations with state banking regulators if it determines that the state examination is an acceptable substitute. For some states with smaller banking departments, the FDIC typically performs joint examinations for which one examination report is signed by both the FDIC and the state banking department.

Under the FDI Act, the Federal Financial Institutions Examination Council (FFIEC)<sup>6</sup> is responsible for issuing guidelines and establishing standards for determining the adequacy of state examinations. The FFIEC guidelines for relying on state examinations, issued in June 1995, stipulate that the federal banking agencies will “accept and rely on State reports of examination in all cases in which it is determined that State examinations enable the Federal banking agencies to effectively carry out their supervisory responsibilities.” Further, the guidelines note that the following criteria may be considered, in whole or in part, by a federal banking agency when determining the acceptability of a state report of examination under section 10(d) of the FDI Act:

- The completeness of the state examination report.
- The adequacy of documentation maintained routinely by state examiners to support observations made in examination reports.
- The ability, over time, of a state banking department to achieve examination objectives.
- The adequacy of any formal or informal arrangement or working agreement between a state banking department and the federal banking agency.

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<sup>5</sup> In addition to safety and soundness examinations, banks are subject to other types of examinations such as information technology, compliance, and trust examinations.

<sup>6</sup> The FFIEC is a congressionally established interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the Board of Governors of the Federal Reserve System, the FDIC, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision and to make recommendations to promote uniformity in the supervision of financial institutions.

## RESULTS OF AUDIT

Overall, the FDIC's process for relying on state safety and soundness examinations is adequate. However, we found opportunities for improvement pertaining to: (1) the FDIC's consideration of the adequacy of documentation maintained by state examiners to support examination reports and (2) the working agreements between the FDIC and state banking departments. Specifically, we noted the following:

- The FDIC could do more to ensure the quality of state examination reports upon which it is relying extensively;
- The working agreements are outdated because some of the agreements do not contain the most current examination frequency requirements, and none of the agreements address the current guidelines implemented by FDIC to improve examination efficiencies at institutions with lower risk profiles; and
- Some working agreements do not address workpaper sharing or coordination of supervisory actions.

To enhance the process the FDIC uses to rely on state safety and soundness examinations, we are recommending that the Corporation, in cooperation with state banking departments, update the working agreements to address these conditions.

## PROCESS FOR RELYING ON STATE SAFETY AND SOUNDNESS EXAMINATIONS

The FDIC relies extensively on state examinations to extend the amount of time between its own examinations. Over the past 2 years, approximately 41 percent of all safety and soundness examinations of FDIC-supervised banks were performed by state banking departments. Additionally, during the same period, state and FDIC examiners jointly performed 15 percent of the examinations as noted in the table below.

### **Safety and Soundness Examinations Completed From January 1, 2002 Through December 31, 2003**

Regulator	2002	2003	Total	Percent of Total
FDIC	1,883	1,728	3,611	44
States	1,763	1,623	3,386	41
Joint (FDIC & State)	579	631	1,210	15
<b>Total</b>	<b>4,225</b>	<b>3,982</b>	<b>8,207</b>	<b>100</b>

Source: DSC information systems.

We determined that the FDIC's process for relying on state safety and soundness examinations is adequate. All state examination reports are routinely reviewed by DSC case managers to determine whether state-assigned CAMELS ratings are appropriate. In addition, the FDIC has entered into working agreements with 48 state banking departments that address, among other things, the scheduling and frequency of examinations, types of examinations to be conducted, and procedures for coordinating enforcement actions.

According to DSC officials we met with in New York and Dallas, the most significant factors that enable DSC to rely on state examinations are as follows:

- DSC has a long history of working with the state banking departments, which has resulted in familiarity with state examiner work products and has helped to achieve consistency in state examinations.
- DSC has ongoing coordination and communication with the states, including periodic meetings between regional office management and the state commissioners and their senior staff, and more frequent communication at the case manager and field supervisor levels.
- Most states use the FDIC's core training schools and have a commissioning process similar to that of the FDIC.
- Forty three (86 percent) of 50 state banking departments are accredited by the Conference of State Bank Supervisors (CSBS) and are subject to periodic recertification.
- Every state examination report is reviewed by a DSC case manager to determine whether the CAMELS ratings are appropriate. If concerns are noted, case managers or field supervisors discuss the concerns with the state and, if deemed necessary, DSC performs a targeted review (visitation) to investigate the matter.

DSC officials also stated that much of the risk related to this process is mitigated by the fact that generally, only institutions with a CAMELS<sup>7</sup> rating of 1 or 2 are examined on an alternating basis with state banking departments. In addition, working agreements with many states specify that alternating exams will be performed for institutions with assets under \$250 million. As a result, the FDIC and state banking departments typically perform joint examinations on institutions rated 3 or lower and on institutions with assets in excess of \$250 million. Of the 5,303 state-chartered institutions the FDIC supervised as of December 31, 2003, approximately 4,230 (80 percent) had assets under \$250 million.

To determine the adequacy of the FDIC's process used to rely on state examination reports, we compared the process with the FFIEC guidelines described earlier. The results of our analysis follow.

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<sup>7</sup> CAMELS (Capital, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk) are the rating factors used by federal regulators in examining the safety and soundness of FDIC-insured institutions. A rating of "1" through "5" is given, with "1" indicating the least regulatory concern and "5" indicating the greatest concern.

## Completeness of State Examination Reports

The FFIEC guidelines note that the state report of examination of a state-chartered, insured depository institution or a state-chartered branch or agency of a foreign bank should contain sufficient information to permit a reviewer to make an independent determination on the overall condition of the institution as well as each component factor and composite rating assigned under the Uniform Financial Institutions Rating System used for insured depository institutions and commonly referred to as the “CAMELS” rating system.

Further, the DSC *Case Managers Procedures Manual* provides the following information about relying on state examination reports:

Case managers review examination reports prepared by the State Authorities to ensure that all risks to the deposit insurance funds have been identified and that appropriate corrective actions are being taken. Prior to the review of a State-prepared examination report, case managers should also review relevant information such as the previous report, correspondence received since the previous examination, the UBPR [Uniform Bank Performance Report], offsite monitoring systems, and all memoranda and documentation submitted with the report of examination.

According to DSC officials in Dallas and New York, only state-prepared examination reports that are of sufficient scope to support the assigned CAMELS rating are accepted by the FDIC. Case managers review each report to ensure that the assigned CAMELS ratings are appropriate and to determine the appropriateness of any existing or proposed corrective action. The case managers discuss with state officials any concerns that might impact a rating to resolve them. After their review, case managers prepare a Summary Analysis of Examination Report (SAER) that summarizes the report and documents their acceptance of the state examination report. The *Case Managers Procedures Manual* also provides that if the FDIC either does not accept the state's report of examination or accepts the examination report but disagrees with the assigned rating, case managers (with the approval of the Regional Director or designee) should discuss the FDIC's concerns and position with the state authority.

Our review of SAER data for 22 state examinations performed in the New York and Dallas regions showed that case managers reviewed each report of examination and SAERs addressing the banks' financial condition and the CAMELS ratings. Case managers did not question the CAMELS ratings and did not have any concerns with the ratings assigned in any of the reports.

Our review of examination data indicated that the FDIC accepts virtually all state examination reports. The FDIC accepted all the 2002 and 2003 state examination reports completed for banks in the Dallas and New York regions. As DSC officials in New York and Dallas explained, when a state examination report contains areas of concern, DSC contacts the state banking department to discuss the areas of concern. If questions remain after discussing the report with state banking officials, the FDIC has two alternatives – accelerate the next examination or perform a targeted review (visitation) of the areas of concern. The usual alternative is to perform a visitation. Our review of visitations performed during 2003 in the New York and Dallas regions indicated that none of the visitations were due to a questionable state examination rating.

## **Adequacy of Documentation Maintained Routinely by State Examiners to Support Observations Made in Examination Reports**

The FFIEC guidelines note that a federal agency should consider adequacy of documentation maintained routinely by state examiners to support observations made in examination reports. However, in that regard, the FDIC does not review state workpapers when determining whether a state examination report is acceptable and has limited knowledge of states' quality assurance programs. According to DSC officials, reviewing state workpapers would be burdensome and conducting such reviews and knowing about state quality assurance programs is unnecessary. Nevertheless, lacking these controls, DSC's assurance that state examinations are reliable is decreased.

Case managers we interviewed stated that the documentation necessary to determine the quality of an examination report is contained in the report itself and as a result, reviewing workpapers is not necessary. In addition, workpapers from state examinations are available and frequently requested for background purposes in conjunction with the next FDIC examination. Further, DSC officials stated that they rely on a general knowledge of state documentation practices and the fact that many states use FDIC work programs for documenting examination findings. Dallas and New York DSC officials stated that they are able to adequately assess the quality of examination reports based on the report content and other available information such as Call Reports.<sup>8</sup>

We did not find any weaknesses or problems that would warrant detailed reviews of state workpapers prior to acceptance of state examination reports. However, DSC could be doing more to ensure that state examination reports are adequately supported. For example, DSC could determine whether state banking departments have a quality control and assurance process similar to the one used by DSC. DSC has a number of programs in place that address quality control and assurance. Principally, DSC performs periodic reviews of regional office and field office procedures. As part of those reviews, examiner workpapers are reviewed to determine whether findings in examination reports are adequately documented and supported. These reviews help to ensure consistency and quality throughout the country.

The General Accounting Office's (GAO) *Standards for Internal Control*, and similarly, the Committee of Sponsoring Organizations of the Treadway Commission's (referred to as COSO) *Internal Control — Integrated Framework* discuss five interrelated components of internal control. One of these components is "monitoring." Internal control systems need to be monitored by assessing the quality of the system's performance over time. This is accomplished through ongoing monitoring activities, separate evaluations, or a combination of the two. Ongoing monitoring should include regular management- and supervisory-level activities and those taken by personnel in performing their duties. The scope and frequency of separate evaluations will depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures. Such evaluations are typically part of an organization's quality assurance program.

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<sup>8</sup> Federal regulators require banks to file quarterly Consolidated Reports of Condition or Call Reports, which contain a balance sheet, income statement, and other detailed financial schedules containing information about the institution.



The DSC officials we interviewed did not know and did not believe it was necessary to know whether states have internal review or quality control processes to test the adequacy of examination report documentation. Rather, the officials rely on the region's historical knowledge of the state banking department and the individual review of each state-prepared examination report. To achieve greater assurance that state banking departments are issuing quality examination reports, the working agreements should establish the expectation that internal control monitoring activities, such as quality control programs, are in place and operating effectively.

### **Ability of State Banking Departments to Achieve Examination Objectives**

The process FDIC uses to assess the ability of state banking departments to achieve examination objectives is reasonable. The FDIC relies on a number of factors to determine whether state banking departments are able to achieve examination objectives in accordance with the FFIEC guidelines, as discussed below.

- **FDIC Examiner Training.** Most states participate in the FDIC's examiner training courses. Although there is no formal agreement between the FDIC and the banking departments concerning examiner training, the FDIC makes training available to all state banking departments. Attendees are not charged tuition and are provided lodging at the FDIC training center without cost. Based on information we obtained from the FDIC's training center, 432 examiners from 38 states participated in various FDIC training courses for examiners during 2003.
- **Examiner Commissioning/Certification Programs.** States in the New York and Dallas regions have an examiner commissioning process similar to that of the FDIC and Federal Reserve. Many states use the FDIC training center, and state examiners progress through a commissioning process much like FDIC examiners.

Most states also participate in an examiner Certification Program sponsored by the CSBS. The program is primarily based on a candidate's educational background and on-the-job-training. Participation in this voluntary program is open to all interested parties who take CSBS training and/or CSBS-sanctioned training. Certification requires appropriate technical skills, on-the-job experience, and attestation by the candidate's supervisor or the respective state bank commissioner. According to the CSBS, more than 600 examiners in 36 states have received CSBS certification.

- **CSBS Accreditation.** The CSBS is the professional association of state banking departments responsible for chartering, regulating, and supervising the nation's state-chartered banks. To become accredited, state banking departments submit to a review of critical elements that assures the ability of these departments to discharge their responsibilities. This review includes an investigation of department administration and finances, personnel policies and practices, training programs, examination policies and practices, supervisory procedures, and statutory powers. As a means of monitoring a department's compliance with CSBS performance standards, every accredited banking

department is subject to annual review by CSBS consultants who are experienced regulators. As of December 31, 2003, 43 states have CSBS-accredited banking departments.

According to FFIEC and FDIC criteria, the FDIC should consider the adequacy of state budgeting and examiner staffing in determining reliance placed on state examinations. Generally, the adequacy of state budgets and staffing levels are addressed at various meetings between the FDIC and state banking departments. DSC officials in Dallas and New York periodically meet with state banking department officials to discuss examination scheduling. Budgeting or staffing problems are discussed at these meetings.

**Budgeting:** To assess state budgeting, we obtained and reviewed budget information for each state banking department for 2002 and 2003. We found that of the 40 states that had provided budgeting data to the CSBS for 2003, 32 states were funded at the same or higher level than in 2002. The remaining eight states incurred only negligible budget cuts.

**Staffing:** Regarding state staffing levels, we reviewed delinquent examinations by states in the Dallas and New York regions. Examination delinquencies were minimal for these regions. According to the delinquency report information in the New York Regional Office, 13 delinquencies out of 635 banks were reported as of September 30, 2003. The delinquencies ranged from 1 month to 7 months. These banks had CAMELS composite ratings of either 1 or 2 with the exception of two banks, which had composite 3 ratings. We noted that the delays were not attributable to inadequate staffing but rather were planned delays due to pending merger activity or to banks that were changing computer systems.

Similarly, we reviewed reported delinquent examinations in the Dallas Regional Office as of September 30, 2003. We determined that only 6 out of 998 banks were listed in the delinquency report. The delinquencies also ranged from 1 to 7 months, and all of these banks were rated 1 and 2. Again, the delays were primarily attributable to pending merger activity or to banks that were changing computer systems.

### **Adequacy of Working Agreements**

The FFIEC guidelines state that a federal agency should consider the adequacy of any formal or informal arrangement or working agreement between a state banking department and the federal agency. To that end, the FDIC has entered into working agreements with 48 states. The majority of these agreements stem from a joint resolution entered into by the CSBS and the FDIC on April 12, 1992. The purpose of the resolution was to develop an examination program that “achieves the goals of improving supervisory efficiencies while reducing regulatory burdens on the banking industry.” The joint resolution encouraged the negotiation and formation of working agreements with the state banking departments. Based on our discussions with officials from the Dallas and New York regional offices and the CSBS, these agreements are working as intended and have resulted in improved supervisory efficiencies and reduced regulatory burdens on the banking industry by ensuring that the FDIC alternates examinations with most state banking departments.

According to the *DSC Manual of Examination Policies* (Exam Manual), the FDIC intends to continue these cooperative efforts to the maximum extent possible. These working agreements are considered informal arrangements that generally address the following areas:

- The number of state-chartered insured institutions to be examined on an alternating basis by the state banking department and by the FDIC.
- The frequency of safety and soundness examinations.
- The type of examinations to be conducted (independent, joint, or concurrent) by each agency.
- The pre-examination procedures to be performed.
- The responsibilities of each agency for processing reports of examination.
- The responsibilities of each agency for conducting specialty examinations.
- The procedures for coordinating informal and formal enforcement actions.
- The procedures for reviewing and acting on applications (for example, for the establishment of a branch office) from banks.
- The procedures for sharing supervisory information.

The working agreements are structured to give both federal and state regulators the flexibility to conduct an independent examination subject only to notification to the other party. Generally, only institutions rated 1 or 2 are examined on an alternating basis, allowing for a reasonable interval between examinations. The Exam Manual notes that the program is designed to be flexible and to tailor cooperation to the particulars of each state.

The Exam Manual further notes that every effort should be made to coordinate examination schedules with state authorities to take advantage of state resources, to minimize duplications of effort, and to lessen business disruptions to the institutions. A representative of the DSC regional office should meet with representatives from each state banking authority to determine examination responsibilities for the upcoming year. Responsibilities may be defined in broad categories by rating, size, and location of institution, or may be defined by specific institution as deemed appropriate. Such agreements should contain enough flexibility to allow either party to alter schedules with minimal notice.

Our review of the working agreements identified opportunities for the FDIC to enhance the existing working agreements. Specifically:

- the working agreements are outdated,
- 12 agreements lacked workpaper sharing provisions, and
- 11 agreements did not address coordination of supervisory actions.

## **Outdated Working Agreements**

Some working agreements are several years old and are in need of revision or amendment in light of changes that have occurred since they were originally signed.

The Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA) was passed in September 1996 and allowed eligible institutions with a CAMELS 2 rating and assets up to \$250 million<sup>9</sup> to be examined every 18 months, rather than every 12 months. Two working agreements entered into before September 1996 do not contain the latest examination frequency requirements. The working agreements with Nevada and Alaska provide that 2-rated banks with assets of \$100 million or more should be examined every 12 months, even though under current examination frequency requirements, 2-rated banks may be on an 18-month cycle if their total assets are less than \$250 million. Although the 18-month guidelines are being applied, the FDIC and the respective state banking departments should amend the working agreement to reflect current examination frequency requirements.

In addition, many of the working agreements were entered into before the implementation of the Maximum Efficiency, Risk-focused, Institution Targeted (MERIT) guidelines in 2002. The MERIT program provides for streamlined examination procedures in well-rated banks with total assets of \$250 million or less and was amended in January 2004 to raise this threshold to \$1 billion. None of the working agreements addressed the MERIT examination program or whether the states are participating in the program.

## **Workpaper Sharing**

Twelve working agreements do not address workpaper sharing. DSC officials in Dallas and New York told us that they usually obtained the workpapers from the prior examination as a starting point and that sharing of workpapers has not been a problem in those regions.

Some agreements contained the following statement, “Each party shall, upon request, make available to the other party all workpapers, line sheets, and other data used in connection with any examination conducted by the party.” To help ensure that the FDIC has consistent access to workpapers nationwide and to promote the sharing of information, the FDIC should strive to ensure that all working agreements contain similar language.

## **Supervisory Actions**

Eleven working agreements did not address supervisory actions. Supervisory actions are often necessary when a bank has weaknesses which, if not corrected, could become worse. Many agreements that did address supervisory actions contained the following provision:

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<sup>9</sup> Specifically, section 2221 of EGRPRA (Pub L. No. 104-288) increased the asset amount to \$250 million from \$175 million that had been established by previous legislation.

In any instance where formal supervisory action is deemed appropriate, the initiating party will inform the other party of the contemplated action. Whenever possible, and if both parties agree, supervisory actions will be taken on a joint basis. However, nothing in this agreement shall prohibit either the Department or the FDIC from implementing a supervisory action unilaterally.

To help enhance the process the FDIC uses to rely on state safety and soundness examinations and to promote mutual understanding of current requirements, the FDIC should strive to revise and update the working agreements.

## **RECOMMENDATION**

We recommend that the Director, DSC, in cooperation with state banking departments, amend working agreements, based on a model agreement, that address, among other things:

- current examination frequency requirements,
- workpaper sharing,
- coordinating examination programs and supervisory actions, and
- encouraging the mutual support of efforts to maintain quality control programs.

## **CORPORATION COMMENTS**

On March 18, 2004, the DSC Director provided a written response to the draft report. The response is presented in Appendix III to this report. DSC generally concurred with the report's findings and agreed to include in a model agreement, language that endorses the general principles of our recommendation for consideration by its regional offices and state banking departments. A summary of the Director's comments on each aspect of our recommendation follows.

### **Examination Frequency**

The Director, DSC, noted that only two agreements do not include current examination frequency requirements and that the region has been informed of the need to amend those agreements.

### **Workpaper Sharing**

The Director, DSC, stated that the 12 agreements without workpaper provisions have been identified and those regions have been informed of the need to amend those agreements with the states' cooperation.

## **Coordinating Examination Programs and Supervisory Actions**

The Director, DSC, responded that the working agreements have never addressed the issue of examination scope or FDIC programs designed to achieve examination efficiencies. The Director further noted that the inclusion of examination procedures and program guidelines such as MERIT in the working agreements would require continual revision of the agreements. DSC believes that the more appropriate approach is through existing cooperative efforts with the CSBS, joint examination and training efforts, and other regulator meetings with the states. However, DSC agreed to endorse the general principle of using common examination programs in the model agreement.

With respect to supervisory actions, the Director stated that the 11 agreements without a provision that addresses coordination have been identified. The regions were aware of these exceptions, and the agreements were written in that manner at the request of state banking departments.

## **Quality Control**

DSC agrees it is important for the division to do all it can to ensure that state banking departments have a sound quality control and assurance program. DSC believes that adequate programs are already in place to validate the quality of state examination reports and supporting workpapers. Specifically, the Director stated that the report should have more fully considered the role that the CSBS Accreditation Program plays in this area and does not recognize that workpapers from state examiners are reviewed in conjunction with conducting joint examinations with the state banking departments. Nevertheless, DSC agreed to include language that endorses the general principle of quality control in the model agreement.

## **OIG EVALUATION**

DSC's planned corrective action adequately addresses the intent of our recommendation. Accordingly, the recommendation is resolved but will remain undispositioned and open until we have determined that the agreed-to corrective action has been implemented and is effective.

With respect to DSC concerns about including MERIT procedures in the working agreements, the intent of the report was not to specifically focus on the MERIT program. Instead, given MERIT's significance to DSC's overall supervisory strategy, we used that program to illustrate how the working agreements could be enhanced by a provision for coordinating examination programs, maintaining a consistent supervisory approach, and possibly easing regulatory burden for institutions.

In regard to coordinating supervisory actions, we recognize that some states may prefer not to issue joint supervisory actions. However, to promote efficiency and consistency nationwide, we contend that coordination is still needed even when actions are not issued jointly. Accordingly, we believe it would be beneficial to both the FDIC and the 11 state banking departments to include language on supervisory actions similar to all of the other working agreements.

Finally, the Director expressed concern with our consideration of the CSBS role in quality control of state banking department examinations and working papers. The report addresses the CSBS accreditation process and recognizes its importance in helping state banking departments discharge their supervisory responsibilities. Based on conversations we had with CSBS officials, however, we were not convinced that the accreditation program in and of itself satisfactorily addresses the FFIEC criteria that a federal agency should consider the adequacy of documentation maintained routinely by state examiners to support observations made in examination reports. CSBS accreditation is an important external quality assurance review. However, the accreditation compliments but does not replace internal quality control activities. The FDIC and state banking departments should use the working agreements to demonstrate their commitment to ensuring adequate quality controls were in place and operating as intended. Further, with regard to FDIC examiners reviewing state examiner working papers during joint examinations, our experiences in other audits have shown that state workpapers are sometimes reviewed for clarity and understanding but are not formally reviewed for quality control purposes. As previously stated, we do not consider it necessary for the FDIC to routinely review state examination working papers from a quality control perspective where there is appropriate attention to quality control activities.

## **OBJECTIVE, SCOPE, AND METHODOLOGY**

The objective of the audit was to determine whether the process used by the FDIC to rely on state safety and soundness examinations is adequate. The audit field work was performed at the DSC regional offices in Dallas, Texas and New York, New York, as we believed these offices would be representative of DSC policies nationwide. We performed our audit from June 2003 through December 31, 2003 in accordance with generally accepted government auditing standards. To accomplish the audit objectives, we:

- obtained and reviewed all working agreements between the FDIC and state banking departments,
- interviewed CSBS officials,
- analyzed a sample of SAER reports and comments applicable to state examinations,
- reviewed various bank examination data from DSC's Virtual Supervisory Information on the Net (VISION) system,
- reviewed DSC policies pertaining to accepting state examinations,
- reviewed FFIEC guidelines for relying on state examination reports,
- interviewed officials in DSC regional offices regarding state examinations,
- reviewed examination delinquency reports; and
- reviewed various state banking department budgets and staffing levels for 2002 and 2003.

### **Government Performance and Results Act, Reliance on Computer-Generated Data, Fraud and Illegal Acts, and Management Controls**

The limited nature of the audit objective did not require reviewing related performance measures under the Government Performance and Results Act or determining the reliability of computer-processed data obtained from the FDIC's computerized systems. Not performing assessments of these areas did not affect the results of our audit. Our audit program did include steps for providing reasonable assurance of detecting fraud or illegal acts. Additionally, we gained an understanding of relevant control activities by examining DSC-applicable policies and procedures as presented in the *DSC Manual of Examination Policies* and Regional Directors Memoranda.

### **Pertinent Laws and Regulations**

Under section 10(d) of the FDI Act, all FDIC-insured institutions are required to undergo on-site examinations by a federal regulator every 12 or 18 months, depending on asset size and bank performance. Under the Act, federal regulators may alternate bank examinations with state banking regulators if they determine that the state examination is an acceptable substitute. Our testing of FDIC's compliance with laws and regulations was limited to the aforementioned parts



of section 10(d) of the FDI Act. With the exception of a few delinquent examinations, we did not find any instances in which the FDIC was not in compliance with pertinent laws and regulations.

### **Summary of Prior Audit Coverage**

The Office of Inspector General (OIG) completed one previous review of FDIC's reliance on state examinations. The audit report entitled, *Audit of Division of Supervision Reliance on State Examinations* (Audit Report No. 99-032), was issued August 4, 1999. The OIG found that while the process for relying on state examinations was adequate, a number of working agreements were outdated and that the FDIC had not entered into a working agreement with several states. We made two recommendations to address those areas. Our current audit identified similar concerns over working agreements that needed to be updated.

## STATE WORKING AGREEMENTS AND CSBS ACCREDITATIONS

State	Date of Working Agreement	Workpapers Sharing Provisions	CSBS Accredited	Date Accredited
<b>Atlanta Region</b>				
Alabama	April 2003	Yes	Yes	December 23, 1996
Florida	December 1999	Yes	Yes	October 16, 1986
Georgia	April 2000	Yes	Yes	December 1, 1992
North Carolina	April 2003	Yes	Yes	October 1, 1997
South Carolina	April 2003	Yes	No	
Virginia	June 2003	Yes	Yes	July 30, 1999
West Virginia	September 2001	Yes	Yes	August 21, 1996
<b>Chicago Region</b>				
Illinois	November 1999	Yes	Yes	December 4, 1984
Indiana	July 1998	No	Yes	March 14, 1988
Michigan	August 1999	Yes	Yes	April 28, 1986
Ohio	August 1999	Yes	Yes	October 24, 1989
Wisconsin	August 1999	Yes	Yes	August 8, 1988
Kentucky	March 1998	Yes	Yes	November 2, 1992
<b>Dallas Region</b>				
Colorado	May 2003	Yes	Yes	January 4, 1991
New Mexico	September 2001	Yes	Yes	May 3, 1996
Oklahoma	August 2001	Yes	Yes	March 23, 1994
Texas	May 2002	Yes	Yes	October 27, 1993
<b>Memphis Area</b>				
Arkansas	October 2003	Yes	Yes	August 8, 1988
Louisiana	April 1997	Yes	Yes	January 14, 1989
Mississippi	November 2002	Yes	Yes	June 6, 1996
Tennessee	April 2001	Yes	Yes	April 27, 1987
<b>Kansas City Region</b>				
Iowa	April 2002	Yes	Yes	June 11, 1985
Kansas	January 2004	Yes	Yes	May 26, 1995
Minnesota	June 1997	No	Yes	November 28, 1990
Missouri	June 2002	Yes	Yes	April 3, 1987
Nebraska	September 1999	Yes	Yes	March 18, 1993
North Dakota	September 1999	Yes	Yes	December 16, 1992
South Dakota	January 2000	Yes	No	
<b>New York Region</b>				
Delaware	February 1999	Yes	Yes	December 23, 1996
Maryland	November 2002	Yes	Yes	July 13, 1992
New Jersey	November 1999	Yes	Yes	October 24, 1986
New York	July 1996	Yes	Yes	October 15, 1985
Pennsylvania	July 1997	No	Yes	February 28, 1986

## APPENDIX II

State	Date of Working Agreement	Workpapers Sharing Provisions	CSBS Accredited	Date Accredited
<b>Boston Area</b>				
Connecticut	February 2000	Yes	Yes	April 28, 1986
Maine	January 2000	Yes	Yes	October 21, 1996
Massachusetts	January 2000	Yes	Yes	December 6, 1994
New Hampshire	February 2000	Yes	No	
Rhode Island	N/A	N/A	No	
Vermont	N/A	N/A	Yes	December 8, 1995
<b>San Francisco Region</b>				
Alaska	May 1995	No	No	
Arizona	September 2003	No	Yes	July 5, 1996
California	February 1997	No	Yes	April 6, 1990
Hawaii	August 2003	No	Yes	March 30, 1990
Idaho	August 2003	Yes	Yes	January 8, 1990
Montana	February 2002	No	No	
Nevada	June 1995	No	No	
Oregon	August 2003	No	Yes	October 22, 1992
Utah	November 2003	No	Yes	October 27, 1994
Washington	January 2003	Yes	Yes	September 17, 1990
Wyoming	August 2003	No	Yes	July 20, 1992

## CORPORATION COMMENTS



**Federal Deposit Insurance Corporation**  
550 17th St. NW Washington DC, 20429

Division of Supervision and Consumer Protection

March 18, 2004

**TO:** Stephen M. Beard  
Deputy Assistant Inspector General for Audits

**FROM:** Michael J. Zamorski *Michael J. Zamorski*  
Director

**SUBJECT:** Draft Report Entitled *FDIC's Reliance on State Safety and Soundness Examinations* (Assignment No. 2003-035)

The Division of Supervision and Consumer Protection (DSC) appreciates the opportunity to respond to this Draft Report prepared by the FDIC's Office of Inspector General (OIG). As the results of the audit show, DSC's process for relying on state safety and soundness examinations is adequate. The report identifies a few opportunities for improvement pertaining to: (1) the working agreements between the FDIC and state banking departments and (2) the FDIC's consideration of the adequacy of documentation maintained by state examiners to support examination reports.

We generally concur with these findings and will take action regarding the recommended opportunities as noted below. In fact, many of these actions have already been taken.

We do believe some areas of the report need further comment. The report states: "DSC could be doing more to ensure that state examination reports are adequately supported. For example, DSC could determine whether state banking departments have a quality control and assurance process similar to the one used by DSC." We do not disagree that it is important for DSC to do all we can to ensure that state banking departments have a sound quality control and assurance program. It should be noted that the report states it did not find any weaknesses or problems that would warrant detailed reviews of state workpapers prior to the acceptance of state examination reports. However, the report does not recognize the role the Conference of State Banking Supervisors ("CSBS") Accreditation Program provides in this area. Quality control is the key component of the CSBS Accreditation Program and we think it is appropriate for DSC to work with the CSBS to ensure that quality control and assurance processes are adequately covered. We think the Report should have more fully considered the role of the CSBS Accreditation Program and recognized that this area is outside the scope of the Working Agreements. Also, while the Report notes that workpapers from state examinations are frequently reviewed in conjunction with the next FDIC examination, the Report does not recognize that workpapers from state examiners are reviewed as they are prepared in conjunction with the many joint examinations with the FDIC. The review of workpapers during joint examinations provides the FDIC with an immediate and continuous method to ensure the quality of the states' documentation methods.

## CORPORATION COMMENTS

Another issue which we believe deserves further comment is the observation that “None of the working agreements addressed the MERIT examination program or whether the states are participating in the program.” While this is an accurate statement, it is important to recognize that the working agreements have never addressed the issue of examination scope or FDIC programs designed to achieve examination efficiencies. The purpose of the working agreements is to define the frequency of examinations and whether the FDIC and State will conduct concurrent, joint, or independent examinations. Including examination procedures and program guidelines in working agreements would require continual revision of the working agreements as procedures are revised and refined. As with the quality control and assurance issue, the FDIC works closely with the CSBS to keep all the states fully informed of our examination programs and to encourage the states to develop and use examination programs that are consistent with our approach. It is through these efforts and our joint training programs that we help the states develop examination programs that are similar to the FDIC. It should also be recognized that the states work closely with the Federal Reserve and they must also consider the examination practices and programs of that regulator as well.

Finally, the Report includes the observation that “Eleven working agreements did not address supervisory actions.” We have been informed by the regional offices that all of these agreements do not address the coordination of supervisory actions at the request of each respective State. These states do not desire to issue joint actions with us. Moreover, the laws and regulations of each state differ as to whether a state has the authority to enter into joint supervisory actions. While we agree it is important to keep each other informed of our intent to issue supervisory actions, we believe that this area should be addressed on a case-by-case basis.

**Response to Recommendation**

**The OIG recommends that the Director, DSC, in cooperation with state banking departments, amend working agreements, based on a model agreement, which addresses, among other things:**

- current examination frequency requirements,
- workpaper sharing,
- coordinating examination programs and supervisory actions, and
- encouraging the mutual support of efforts to maintain quality control programs.

**DSC’s Response:**

We generally concur with this recommendation, though we believe that some of the specific elements listed are better addressed outside of the working agreements themselves. Specifically, the coordination of examination programs and methods and the encouragement of quality control programs have long been addressed through interagency working groups at both the national and regional levels.

## CORPORATION COMMENTS

DSC agrees to provide the regions with a model agreement that addresses all the issues identified in the *Manual of Examination Policies*, including those items specified in the Recommendation. We will send the model agreement to the regions before September 30, 2004. We will ask the regional offices to review their working agreements and work with the states to amend as appropriate any working agreements that do not cover these issues. As noted earlier, the states are joint partners in these working agreements and we cannot force them to include any provisions that they do not want to include. We will also fully discuss this Report and DSC's response at the next management meeting with the Regional Directors by June 30.

The regions have already reviewed their agreements as a result of this audit and have already identified those agreements that do not include all these provisions. Only two agreements do not include current examination frequency requirements and that region has been informed of the need to amend those agreements. Also, the twelve agreements without workpaper provisions have been identified and those regions have been informed of the need to amend those agreements, with the states' cooperation. Finally, the eleven agreements without a provision that addresses coordination of supervisory actions have been identified. The regions were all aware of these exceptions and informed us that each exception was at the request of that particular state.

While we agree that the use of common examination programs and the mutual support of efforts to maintain quality control programs are important issues for our attention, we do not believe that the working agreements should include specific provisions addressing them. Regarding the coordination of examination programs, we believe the more appropriate approach is through existing cooperative efforts with the CSBS, joint examination and training efforts, and other regulator meetings with the states. Several long-established interagency working groups, such as the Supervisory Processes Committee and the FFIEC's Task Force on Examiner Education, continually foster state adoption and use of common examination report templates, workpaper documentation software, and training programs. With respect to quality control efforts, we believe that we already have adequate programs in place to validate the quality of state examination reports and the supporting workpapers through our joint examination work and through our efforts with the CSBS and its Accreditation Program. Nevertheless, we will include language that endorses these general principles in the model agreement for consideration by the regions and the states.

## MANAGEMENT RESPONSE TO RECOMMENDATION

This table presents the management responses that have been made on recommendations in our report and the status of recommendations as of the date of report issuance. The information in this table is based on management's written response to our report (and subsequent communication with management representatives.)

<b>Recommendation</b>	<b>Corrective Action: Taken or Planned/Status</b>	<b>Expected Completion Date</b>	<b>Monetary Benefits</b>	<b>Resolved:<sup>a</sup> Yes or No</b>	<b>Dispositioned<sup>b</sup> Yes or No</b>	<b>Open or Closed<sup>c</sup></b>
Amend working agreements, based on a model agreement, to address among other things: current examination frequency requirements, workpaper sharing, coordinating examination programs and supervisory actions, and encouraging mutual support of efforts to maintain quality control programs	DSC will provide regions with a model agreement that addresses all of the issues specified in the recommendation. DSC will also discuss the report's contents at the next management meeting with the regional directors.	September 30, 2004	N/A	Yes	No	Open

<sup>a</sup> Resolved – (1) Management concurs with the recommendation and the planned corrective action is consistent with the recommendation.  
(2) Management does not concur with the recommendation but planned alternative action is acceptable to the OIG.  
(3) Management agrees to the OIG monetary benefits or a different amount, or no (\$0) amount. Monetary benefits are considered resolved as long as management provides an amount.

<sup>b</sup> Dispositioned – The agreed-upon corrective action must be implemented, determined to be effective, and the actual amounts of monetary benefits achieved through implementation identified. The OIG is responsible for determining whether the documentation provided by management is adequate to disposition the recommendation.

<sup>c</sup> Once the OIG disposes the recommendation, it can then be closed.